UNITED
NATIONS

E

Economic and Social Council

Distr.
GENERAL

E/1992/45
6 May 1992
ENGLISH
ORIGINAL: ENGLISH/FRENCH

Substantive session of 1992
29 June-31 July 1992
Item 10 of the provisional agenda*

REGIONAL COOPERATION

# Summary of the Economic Survey of Europe in 1991-1992

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# I. THE TRANSITION ECONOMIES IN 1991: AN OVERVIEW

1. For the world economy, 1991 was one of the worst years of the entire post-war period. Global output fell for the first time since 1945 and the growth of world trade fell for the third year in succession. In the market economies of Western Europe and North America, output growth was virtually zero, with a small increase in Europe offset by a fall in North America. An expected recovery in North America and the United Kingdom of Great Britain and Northern Ireland was forecast for the second half of 1991, but this failed to appear and compensate for the sharp slow-down in Germany and Japan. Current forecasts point to a feeble recovery in 1992.

2. In Eastern Europe the depression associated with the break-up of centrally planned economies deepened further, with domestic output levels falling by some 14 per cent. One of the most momentous events of the post-war period occurred with the dissolution of the Soviet Union in December: the year was marked by fruitless efforts to negotiate a new union treaty against a background of growing economic dislocation and large falls in the level of activity.

3. Despite the great hopes and opportunities created by the revolutions of 1989 in Eastern Europe, the general mood is now quite pessimistic. This is no doubt exaggerated and reflects in part the breakdown of previous illusions about the ease and speed with which the transformation of the former "planned" economies could be brought about. Nevertheless, the problems are considerable. It has proved fairly easy to break up the old structures but extremely difficult to build the new. Fixed investment is still falling rapidly in the transition economies: that has to be reversed if the reform process is to succeed and burgeoning unemployment levels to be checked. A growing fear is that the increasing economic strains will lead to disillusion and impatience, both with the idea of a market economy and with the democratic process.

4. If the Western Governments wish to reduce these growing risks, a much greater commitment to the success of the reform process will be needed on their part.

## A. The Soviet Union and the Commonwealth of Independent States

5. In 1991 the Soviet Union effectively broke up when the Presidents of Russia, Ukraine and Belarus declared their republics to be independent and signed the Minsk Agreement of 8 December creating the Commonwealth of Independent States (CIS). By 21 December another eight republics had joined the CIS whose aims now included the building of "democratically law-governed States". On 25 December Mr. Gorbachev resigned the presidency of the USSR and on 26 December the Soviet Union ceased to exist.

6. Much of 1991 had been dominated by attempts to negotiate a new relationship between the republics and the Union and these appeared to have succeeded when a draft agreement was initialed in the summer. Although this draft treaty is likely to have proven unviable, especially in the economic sphere, the reduction in the authority of the Union was such that it was a principal cause of the August coup. From that point, the republics rapidly asserted their full independence. Economically, however, the successor States of the Soviet Union are still highly interdependent, and one of the most urgent tasks now facing them is to create institutions and working arrangements for managing their mutual relations in a constructive manner.

7. The accelerating economic decline of the Soviet Union in 1991 was due essentially to massive disruptions in the supply-side of the economy as a highly specialized division of labour began to break down. With the collapse of central "planning" control and the acceleration of inflation, barter transactions among enterprises have replaced centrally determined enterprise flows settled in roubles. The breakdown of central authority and the emergence of elected local leaders, sensitive to the needs of their constituents, led to restrictions on the outflow of goods, especially consumer products, to other regions. Since the division of labour in the Soviet Union was highly differentiated in terms of geographical distribution as well as function, these developments were particularly damaging and strengthened the tendency towards republican mercantilism. Against this background of increasing barter, curbs on inter-republican transactions and the general dislocation of traditional economic arrangements, there was a large decline in output.

8. For 1991 as a whole, net material product in the Soviet Union/CIS fell by 15 per cent and GDP by 17 per cent. This followed reductions of 4 and 2 per cent respectively in 1990. The downturn was gathering pace throughout the year and accelerated sharply in the last quarter. Short-term forecasts are virtually impossible in the current state of turmoil, but another large fall in output seems probable in 1992. An aggregate decline of 25-30 per cent between 1989 and 1992 would not be implausible in the light of what has happened in Eastern Europe (see below). Although the fall in output last year affected all the individual republics, there were large variations among them. 1/

9. Consumers have suffered, and possibly by more than is indicated by the estimate of a 15 per cent fall in the volume of private consumption, since it is generally believed that the official consumer price index understates the true rise in prices. The compression of already relatively low living standards is continuing in the independent republics in the early months of 1992 and is raising fears that the fragile political and social consensus for market reforms will be increasingly difficult to maintain without substantial help from abroad. These fears are reinforced by the prospect of rapidly rising unemployment in the course of 1992. Statistics on unemployment in the former Soviet Union and in its successor States do not provide a reliable picture of its current extent. At the end of 1991, 1 million people were registered as unemployed in the labour offices of the CIS members. At the end

of 1990 Goskomstat estimated the total, according to definitions of the International Labour Organisation (ILO), at 2 million. Current unofficial estimates, which vary widely, start at around 4 million, but it is extremely difficult to judge the accuracy of such numbers. What does seem clear is that unemployment is now a serious problem and, in the light of experience in Eastern Europe, is likely to grow rapidly as soon as any real restructuring of the economy gets under way.

10. Although a great deal of legislation to support the transition to a market economy was passed in 1990 and especially in the first half of 1991, the principal failures concerned the fundamentals of privatization, price liberalization, monetary and fiscal policies and the pursuit of currency convertibility. In the presence of such lacunae, progress in other areas will have little effect and, in a "second best" world, may be counterproductive. This can be seen clearly in the case of inflation. Open inflation in the Soviet Union first appeared in 1985 as a result of policy errors and the side-effects of partial decentralization. After 1989, and particularly in 1991, there was a marked increase in the fiscal autonomy of the republics. Given the maintenance of a single currency and a passive, accommodating monetary policy at the centre, the republics were able to run up fiscal deficits knowing that the inflationary consequences would be diffused across the entire Union. In such circumstances there was little incentive for the republics to embark on a serious attempt at macroeconomic stabilization and, given the deteriorating relationship between the Union and the republics, there was little chance of monetary control being established at the centre.

11. A solution to this conflict, between the fiscal autonomy of the republics and the continued existence of a single currency and ineffective monetary control, is now the most urgent task facing the successor States of the ex-Soviet Union. Without a solution, macroeconomic stabilization will be impossible; and without stabilization the collapse of supply links between enterprises and republics will continue to the point of destruction.

12. Given the lack of mutual confidence among the successor States and their fears of a re-assertion of control from Moscow, not to mention the strength of national pride in newly-won independence, one possible solution would be to move towards an open trading area with separate currencies. This would require an effective currency reform and a coherent macroeconomic stabilization programme in each republic. The prime institutional requirement is to find ways of establishing monetary control (the absence of effective bank regulations and credit control in the Baltic States is the main reason for their delay in introducing their own currencies). A problem here is that central banks in many of the republics, including Russia, are responsible to parliaments, which tend to be relatively tolerant of inflation. An alternative method of control might be to set up currency boards, which would effectively tie the money supply to changes in the balance of payments. The disadvantage is that the currency boards would probably require much more Western assistance than the amounts required for stabilization funds to support the internal convertibility of the rouble and any new republican

currencies; the advantage is that, assuming there is effective regulation of the commercial banks, the currency board is likely to be a more effective means of financial stabilization.

13. A final ingredient of a programme to establish stable economic relations among the successor States is the need for effective payments arrangements among the different currencies. The issues involved here are much the same as those discussed in the proposal for a payments union among the members of the former Council for Mutual Economic Assistance (CMEA). 2/ The essential objective of a payments union is to avoid an excessive contraction of trade during the period of transition towards current-account convertibility of the republican currencies. Two years ago the warnings of a severe collapse in intra-CMEA trade were ignored, and suggestions that a payment union might be useful as a transition measure were brushed aside. There are signs that the lessons of that collapse have been noted by some CIS members and that they are keen to avoid a repetition.

14. The above measures, if put into effect quickly, would establish a framework for macroeconomic stabilization and for stopping - and perhaps reversing - the rush towards autarky in the successor States of the former Soviet Union. However, if the measures are to be successful, substantial assistance will have to be provided by Western countries and the international institutions. This will have to include large-scale technical assistance in setting up banking and payments institutions as well as significant financial help.

15. The "republicanization" of monetary control will have to be supported by measures to control budget deficits, which means controlling public spending and/or maintaining or increasing tax revenue. Cuts in spending are extremely difficult when all the political pressures are for increases to soften the growing hardships arising from falling real consumption levels, rising unemployment and dislocation in the supply of goods. Western grant aid in the form of food, medicine and medical equipment can assist here in a wider role than a purely emergency one. On the side of revenue, technical assistance is urgently required to set up and operate effective tax collection systems.

16. The stabilization problem is now very urgent. Without significant help from the West in 1992, it is doubtful that domestic efforts alone can be successful. And without effective stabilization it is unlikely that the longer-run programmes for privatization, market liberalization and industrial restructuring can make any progress. Nevertheless, in the absence of adequate help from abroad, the CIS members will probably try to do something on their own and in so doing they are likely to focus on the two sectors where, despite the degradations of the former economic system, their products are still internationally competitive. The first is natural resources; although their development is hampered by supply-side problems which could eventually be overcome with the help of foreign capital and technology; the second is the armaments industry, which could probably resume export growth fairly quickly. An export drive in military weapons, however, would not perhaps be the most welcome form of self-reliance from the point of view of the "new world order".

## B. Eastern Europe

17. In Eastern Europe the difficulties of transforming former Soviet-type systems into decentralized market economies became ever more apparent in 1991. Levels of output continued to fall sharply, even in the few countries where an upturn had been expected, and most people have had to bear large cuts in their standards of living. The popular enthusiasm for a new order that characterized the political revolutions of 1989 has given way to widespread feelings of anxiety and disappointment - and even bitterness that the pace of economic change has been unable to match the speed of political development. The fact that the earlier hopes of rapid economic transformation - encouraged by Western advisers and politicians no less than those in the East - were unrealistic is now irrelevant. Political leaders, not only in Eastern Europe, but also in the West, now have the task of preserving and reinforcing support for economic transformation in the face of increasing current hardships and the disappointment of initial expectations. In particular, they will have to counter the populist and reactionary charge that the hardships of the transition are in fact the "inevitable" properties of a market economy. In this task they will need the practical support of the international organizations and institutions.

18. It is generally accepted that the revolutions of 1989 were not foreseen. This was a major failure of political appreciation and of social science in both the Western countries and in the East. Yet despite this demonstration of a general lack of understanding of the dynamics of economic and social change, the revolutions were quickly followed by Western advisers explaining why there was "no alternative" to doing this or that if the transition to a market economy were to be successful, and by politicians declaring that the transition would be swift and painless. Given the failure to anticipate the upheavals of 1989, a greater amount of pragmatism might have been more appropriate, especially since one implication was that knowledge of the "initial states" from which the transition countries were departing was, at best, rudimentary. This began to be acknowledged at the beginning of 1991. In Germany, officials admitted that they had seriously underestimated the effects of "shock-therapy" on the Länder which had been subject to forty years of Communist rule. 3/ In his New Year's address, President Vaclav Havel referred to the "unpleasant surprises" of the previous year and announced that "the reconstruction we had planned for and looked forward to will take longer and cost far more than we first thought. What a year ago appeared to be a rundown house is in fact a ruin." 4/

19. These errors of analysis are having serious consequences. In Germany, the unexpected escalation in the budgetary costs of supporting reconstruction in the former GDR has led to a sharp increase in inflationary pressures and, via the impact of higher German interest rates working through the exchange rate mechanism of the European Monetary System (EMS), is having a depressing effect on the prospects for the recovery of activity throughout Western Europe. The electorates in the West (including North America) are unprepared for the scale of international assistance that will probably be required to ensure that the transition processes become self-sustaining; and those in the

East are also unprepared for the likely duration of their hardships. As suggested above, the political task of keeping the transition processes on course is now much more difficult than it was two years ago.

20. Another complication in creating realistic expectations and sustaining popular support for the transition process in Eastern Europe is that the destination is usually described in terms of a unique Western model which bears little relation to Western realities. One of the most powerful attractions of market economies and democratic systems is that they greatly enlarge the scope for choosing different arrangements for the conduct of economic and social affairs. There is no single Western model of democracy or of a market economy: around a core set of institutions and values there is considerable variation between, for example, Western Europe and the United States and Japan and even within Western Europe alone. It is also highly misleading to represent Western market economies as being ruled solely by market forces. The great achievement of the Western democracies, especially since the depression of the 1930s, has been to combine market driven efficiency and resource allocation with a concern for equity and social justice. Moreover, the fairly widespread existence of market failure, in the form of externalities or non-competitive behaviour, has led to a variety of forms of Government intervention, ranging from nationalization to various forms of regulation. The workings of Western market economies have therefore been greatly modified by Government intervention, the specific forms of which vary considerably among countries and have changed markedly over time. The policy debates and innovations of the 1980s have not really altered this picture: the State has handed over (or back) certain activities to the private sector in some countries, and there have been important changes in the institutions and forms of regulation of competitive behaviour. These changes have met with varying degrees of success, but one of the major criticisms made of them - in both the United States and the United Kingdom, for example - is that they have led to greater inequality. 5/ This alone is likely to lead to a reappraisal of the policies of the 1980s and to a renewed search for ways of improving the trade-off between equity and efficiency in the 1990s. To ascribe the relative success of the Western market economies solely to the uninhibited workings of free market forces both simplifies and underestimates their achievement: it has been the interactive evolution of a whole range of democratic, social and economic institutions and practices which have ensured the survival of Western "capitalism" and repeatedly falsified the Marxist prediction of its imminent collapse. This is a richer - and more inspiring - picture of "the market economy" than the "stripped-down" market efficiency model that is commonly presented to the electorates of Eastern Europe and of the successor States to the Soviet Union.

21. Many of the people in these countries must now be wondering whether the invisible hand of the market is really an iron fist. In Eastern Europe the depression deepened further in 1991 with domestic output levels falling on average by about 14 per cent. This follows an average fall of 10 per cent in 1990 and 2 per cent in 1989. Since 1988 the aggregate fall in output is nearly 25 per cent.

22. No country escaped the collapse of output in 1991, but the differences were considerable: in Bulgaria the fall was some 23 per cent; in Romania, Yugoslavia and Czechoslovakia, it ranged between 13 and 16 per cent; while in Hungary and Poland it was about 8 per cent.

23. All sectors have been hit by the recession. The fall in industrial output was particularly large in 1991: it averaged about 19 per cent with declines ranging from 12 per cent in Poland, the third successive year of falling output, to a reported 60 per cent in Albania, the poorest and least industrialized country in Europe.

24. Agricultural output also continued to fall, for the third year in succession, although the drop of 1 per cent was less than in 1990. In Yugoslavia output is actually reported to have risen, in both the social and private sectors, and there was also a small increase in Romania.

25. Although the development of the services sector is expected to provide an important boost to economic growth in the medium run, so far this has failed to materialize. However, the decline in the output of services has been less than in output as a whole, so there has been some shift in its share of national output. There is also probably a greater diversity of trends within services than in other sectors of the economies of eastern Europe: transport and trade have been badly affected by the falls in agricultural and industrial output, while health, education and other public services are being hit by the tightening of fiscal policies. However, business and financial services appear to be growing in Hungary and there has been some expansion in the communications sector in Poland.

26. In surveying this general picture of collapsing output in Eastern Europe, a decline which appears to be on the scale of the depression of the 1930s, a number of considerations have to be borne in mind. The first concerns the quality of the statistics on which the picture is based. Although many problems in this respect have been around for a long time, there has probably been a deterioration in the last few years as national statistical offices began to switch to new methods of collection of, in many cases, completely new sets of statistics. 6/ One consequence of this reorganization is that the private sector, particularly small enterprises, and new activities are still not being accurately reflected in the statistics. There is also a shift in reporting bias. Under the former "administered" regimes, enterprises tended to overstate their output levels in various ways in order to satisfy centrally determined targets and to boost their claims for bonuses and an increased allocation of investment funds. Now, the incentive is to understate production in order to avoid paying taxes, an incentive which is strengthened by the embryonic state of tax collection and enforcement systems. These factors probably lead to some exaggeration in the measured decline of production, but until better official figures are produced and published no one really knows the extent of the overstatement. Anecdotal evidence and a general consideration of the various factors influencing activity suggest that it is unlikely to be so large as to alter radically the general picture of a severe decline in production. In Poland and Hungary, the private sector is

relatively more important than elsewhere and it does appear to have been quite dynamic in 1991 in industry, construction and in some service sectors. This is a most encouraging development and one which is probably not fully reflected in the output figures - nevertheless, it is unlikely to have more than partially offset the collapse of the still very much larger State sectors.

27. The extent of the downturn in Eastern Europe is much greater than originally expected, although the disparity probably reflects the unrealism of the initial expectations as much as surprise developments. The proximate causes of the downturn were the introduction of large changes in relative price structures, which are central to price liberalization measures, and the restrictive macroeconomic policies introduced to curb accelerating inflation and government budget deficits. The simultaneous introduction of such policies in several countries generated negative multiplier effects throughout the region, which in turn were greatly amplified by the collapse of trade among the members of the former CMEA. The collapse of trade with the Soviet Union had a major impact on Eastern Europe, especially in the countries of south-eastern Europe where the disruption caused by shortages of energy and other supplies was exacerbated by severe foreign exchange constraints. These various domestic and exogeneous factors have interacted and intensified their ultimate impact on levels of activity.

28. Nevertheless, in spite of all these factors it is important to emphasize that a recession in output was unavoidable. The transition from a Soviet-type economy to a market economy must involve a large relative price shock as the system moves from an administered price structure to one based essentially on competitive world market prices. This shift in relative prices will benefit some activities in the transition economy, but it will weaken the competitiveness of others and of some to the point of extinction. Thus a proportion of the capital stock is rendered economically unprofitable, virtually overnight. How large a proportion will be "knocked out" in this way will depend on a number of factors including the initial disparity between domestic and world prices and on whether there are any arrangements in place to extend the adjustment period. It seems reasonable to assume that a very large proportion of the Eastern European capital stocks have been rendered economically obsolete in the manner described, especially in the industrial sector. 7/ So far, little progress has been made in reducing pollution and other environmental costs in the transition economies: but when action does get under way it will almost certainly lead to further reductions in the viable capital stocks, either through direct regulation or through the internalization of external costs.

29. Rebuilding the productive capacity of the former centrally planned economies requires a strong recovery in fixed investment, but the preconditions for this are not yet in place. Gross fixed investment fell on an average by 23 per cent in 1991, 8/ following declines of 2 and 14 per cent in 1989 and 1990 respectively. In other words, fixed investment has fallen by more than one third since 1988. The fall in fixed investment is general and in some countries (Bulgaria, Poland and Romania) has been under way since 1989. Over the last few years investment has fallen by about 19 per cent in Poland and Hungary and by nearly 50 and 60 per cent in Romania and Bulgaria.

30. The question of fixed investment is at the heart of the transformation process and the conditions for its recovery are largely co-terminous with those required for the transition itself. Private investment - foreign and domestic - is at present held back by a multitude of uncertainties concerning not only the medium-term economic outlook but also the putting into place of the entire structure of laws and institutions which are necessary conditions for a market economy to function. The one country which appears to have made significant progress in this regard is Hungary which attracted nearly $2 billion of foreign direct investment last year: nevertheless, even there, total investment is still falling and there are still few signs of any restructuring in industry.

31. Privatization is generally proving much more difficult than expected. In the leading tier of reformers (Czechoslovakia, Hungary and Poland) it is moving slowly, and elsewhere it has hardly begun. It therefore seems likely that for some time to come there will still be a relatively large State-run sector in the Eastern European economies. This will create problems for incentives in general and for the propensity to invest in particular. Private enterprises will be faced with continued uncertainty over the structure of their domestic markets, and the managers of State enterprises, in the absence of clear pre-privatization programmes (such as break-up (see below)) and commercialization, will have little or no incentive to invest.

32. It is widely assumed that once effective stabilization policies have corrected internal and external imbalances, and with a price reform carried through and a realistic exchange rate in place, private investment will take off to complete the transformation process. However, as the above observations imply and the current situation in Poland suggests, the timing of the two processes may not be synchronized. How can this timing gap be overcome? There seems to be little point in urging Governments to speed up the creation of new legal structures and market institutions. These are complicated matters and Governments are already going as fast as they can. A more effective approach might be to consider more active and explicit industrial policies on the part of Governments: these would include a whole range of "supply-side" measures to raise capacity and competitiveness, increase public infrastructure investment, introduce effective training programmes (including for management), and establish a monitoring system to reveal bottlenecks and market failures and encourage a quick response to remove them. The suggestion of a more active role for Governments may produce ideological reactions on the part of some advisers, but this is a nettle that may have to be grasped if the stabilization-structural transformation sequence does not proceed as it is assumed to do. If Eastern European Governments were to decide on such a course, it would be advisable to do so with the help and advice of one of the international organizations (such as the Organization for Economic Cooperation and Development (OECD)) that are familiar with such policies in the Western market economies.

33. Controlling inflation is a difficult task for the transition economies. They need to introduce programmes of price liberalization and secure significant changes in the structure of relative prices, while at the same

time the legacy of institutions and practices from the previous regime continues to undermine the effectiveness of the traditional tools of macroeconomic policy. Thus, credit policy is frequently being attenuated by the large-scale resort to inter-enterprise credits; and rising unemployment may be accompanied, perversely, by rising wages. 9/ The jump in the price level following price reforms was generally much larger than expected, and although inflation rates subsequently subsided they remain high. In Poland, inflation fell sharply in the first seven months of 1991, but it then accelerated again in the second half of the year, to 44 per cent a year in December. So far, policy makers in Czechoslovakia have been rather more successful in this respect: after the price reform of 1 January 1991, prices rose sharply in the first quarter but decelerated rapidly thereafter, a performance which partly reflects the more favourable conditions in which the Czechoslovak reform was launched but also the very tight control of budgetary policy. However, there was some acceleration again at the end of the year. In south-eastern Europe, the control of inflation is proving even more difficult: there has been a sharp acceleration in Romania and Yugoslavia since last summer, to annual rates of 367 per cent and 644 per cent respectively in December. In Bulgaria the initial acceleration in the rate of inflation following the price reform last February was sharply reduced by the spring, but thereafter it rose again and by December was running at an annual rate of 78 per cent.

34. The persistence of high inflation rates in the transition economies is in many ways a consequence of their transitional state: the "command" economy has been abandoned but many of its micro-economic features remain, weakening or undermining the effectiveness of fiscal and monetary policy. Some improvement can probably be made to the effectiveness of anti-inflationary macroeconomic policies - improvements in tax systems, perhaps a more determined use of incomes policies - but a significant and sustained reduction of inflation will also need more positive supply-side responses to the new relative price structures.

35. In 1990 one sign that the soft budget constraint was still operating in the transition economies was the relatively low levels of unemployment that were prevailing despite the large and widespread falls in output. This has changed considerably in the last year: the number of persons registered as unemployed in Eastern Europe more than doubled in the year to December 1991 when it stood at just under 6 million (excluding the former German Democratic Republic). Unemployment rates in Bulgaria and Poland were some 10-11 per cent in December and some 7-8 per cent in Czechoslovakia and Hungary. In Yugoslavia the rate at the end of the year was nearly 20 per cent. Although there are many uncertainties surrounding the precision of these figures, there seems to be little doubt that there has been a dramatic rise in joblessness in Eastern Europe.

36. As in the Western market economies, the burden of unemployment has tended to fall more heavily on women than on men, on the young, and on manual workers rather than the more educated. The number of long-term unemployed (those without a job for more than a year) also appears to be rising although, given

that open unemployment is a recent phenomenon in Eastern Europe, it is still relatively small compared with the numbers prevailing in Western Europe. Since, as noted above, the restructuring of the transition economies is still in its early stages, both the levels and duration of unemployment can be expected to continue rising even beyond the time at which output begins to recover.

## II. DEMOCRATIC INSTITUTIONS AND THE PROCESS OF ECONOMIC TRANSFORMATION

37. Many of those arguing for the so-called "shock therapy" approach to the transformation of Eastern Europe do so, at least partly, because they fear that the forces of reaction are still strong and that incompetence and/or corruption in the bureaucracies may be holding back the transition process. 10/ This may exaggerate (or misinterpret) the situation in so far as many officials and bureaucrats can adapt quickly to changed conditions: as Edward Gibbon noted, also writing about a collapse of regime, "officers of the police or revenue easily adapt themselves to any form of government". 11/ Not all Government officials will possess the same degree of flexibility, but the key issues obviously include, just as in other sectors of the transition economy, the questions of skills and retraining, and the structure of incentives. Also, the administrative systems themselves will require radical alteration since they were designed to serve a very different political system from the one now being established. Moreover, it is not always a simple matter to distinguish between the faults of individuals and the much larger failings of the system in which they are required to operate. However, from the perspective of building support for the transition process, let alone from that of common justice, the distinction needs to be made. 12/ Clearly, if the economic reforms were to fail - or to look as if they might fail - then these same officials would be looking for the next best alternative rather than fighting for the current objectives. So the expectations of economic success are certainly crucial for gathering and maintaining both popular and bureaucratic support for the transition process. But, having said that, it might be questioned whether it is sensible to burden economic instruments with political and administrative considerations. Instead of, for example, trying to speed up the privatization process so as to remove the influence of incompetent or unqualified officials, it might be wiser to target the deficiencies in administration directly rather than risk a dangerous backlash from a flawed economic reform.

38. It is important to acknowledge the close interdependence between the objectives of economic reform and reconstruction, democratic institution building and security issues in the transition economies, but it is also wise to remember the macroeconomic policy advice to match targets and instruments. In broad terms, administrative instruments should be used to support institutional objectives, and economic instruments should not be overloaded with political targets. The question of privatization can be used to illustrate this point. In Western Europe, the privatization policies of the last decade or so have been essentially concerned with improving economic

efficiency, although some proponents have stressed the adjustment of the border between the democratic State and civil society as a matter of principle. In Eastern Europe the matter of economic efficiency is of course very important, but privatization is also regarded as the most prominent sign of the overthrow of the entire concept of the organic state. 13/ In other words, privatization in the former Communist countries is intimately connected to the creation of democratic States and the re-assertion of the claims of civil society. It is not surprising therefore that there are considerable pressures for privatization to be carried out as quickly as possible. However, the speed of privatization which might satisfy democratic and political objectives could be too fast for avoiding deleterious economic outcomes. It has been persuasively argued 14/ that the State monopolies of the former centrally planned economies should be broken up before they are privatized - otherwise, the highly concentrated production structures, characteristic of Soviet-type economies, would be maintained with a high probability of continued economic stagnation and weak incentives for improving economic efficiency. Such an outcome would not only increase the tensions noted above but would also make it easier to reverse the process at a later date - a possibility which is precisely what the proponents of rapid privatization claim to be avoiding. There are, in addition, many other technical and quasi-technical problems which must be overcome if privatization is to be economically successful. 15/ Skating over such problems in order to speed up the process could lead not only to sub-optimal outcomes but also to a backlash against the private sector as a whole. 16/ There is, however, already an extensive framework 17/ for providing technical expertise and assistance in the building and strengthening of democratic and administrative structures in the transition economies - and no doubt this could be strengthened further. Moreover, a number of conditions concerning respect for democracy, the rule of law and human rights, have already been set as requirements for receiving economic assistance from the G-24 countries and from the European Bank for Reconstruction and Development. 18/ There is, thus, both a framework for Western assistance for strengthening democratic institutions in Eastern Europe and the implicit threat of sanctions against a country which violates the preconditions for assistance. If the framework is used to the full and the threat remains credible, the fears of democrats in Eastern Europe will be reduced and the political overload removed from policies for economic restructuring. 19/

## A. Western economic assistance

39. It is the view of most observers, in all parts of Europe, that the nascent democracies of Eastern Europe would be gravely threatened by a failure of the process of economic transformation. In order to avoid such an outcome, the Governments of the Western market economy countries have launched a number of initiatives to assist the countries of Eastern Europe and the CIS in their attempts to restructure their economies according to market principles. In the past year there has been an increase in the flow of official financial resources to the transition economies, an expansion of technical assistance, and an improvement in access to Western markets for Eastern products. The

established international financial institutions, the World Bank and the IMF, have increased their assistance to Eastern Europe and they have now been joined by the European Bank for Reconstruction and Development, which was inaugurated in April 1991.

40. One of the most important developments has been the improvement of market access to the European Community, which is the largest single western market for eastern goods. Quantitative restrictions on most manufactures had been abolished or suspended by the beginning of 1991 and all the Eastern European countries received Generalized System of Preferences treatment. Agricultural, steel and textile products are subject to separate arrangements, but for the latter two there has been some loosening of restrictions. Important gains in access were obtained by Czechoslovakia, Hungary and Poland as a result of their bilateral Association Agreements with the European Communities, which were signed in December 1991. These provide for the phasing in of free trade in non-agricultural goods between the parties to the Agreements over a 10-year period. 20/ Again, separate provisions apply to sensitive products such as textiles and steel, although there are improvements in both areas. There was, however, little improvement for agricultural products. Nevertheless, the Agreements offer important market opportunities for the Eastern European partners and constitute a significant step towards their full integration into the European economy. One disappointment for the three transition economies was that a date was not fixed for their eventual accession to full membership of the European Community. The setting of a date, however far away, could have had a positive effect in encouraging foreign direct investment in the three countries. Also, some policy makers would have welcomed such a date as a source of pressure in maintaining their progress towards a market economy: a succession of intermediate targets would have had to have been met according to the pre-determined timetable.

41. Trade liberalization is also under way to varying degrees in the other market economies. The EFTA has concluded a free trade agreement with Czechoslovakia and negotiations are continuing with Hungary and Poland; and the United States has improved access under the Trade Enhancement Initiative. It is important that this general movement to liberalize access continues and that it be extended as quickly as possible to all the economies in transition.

42. At the present moment, the outcome of the Uruguay Round is still in the balance, but a successful conclusion could provide important benefits to the Eastern countries. Apart from the gains from a general lowering of trade restrictions, an agreement to lower protection of agriculture in the developed market economies could especially benefit the export earnings of countries such as Bulgaria, Hungary, Poland and Ukraine.

43. Despite the considerable publicity given to the growing number of financial commitments to the transition economies, the amount of genuine aid (grants and concessionary finance) from the West has been small. Between January 1990 and June 1991 the total of commitments of assistance by the G-24 countries to Eastern Europe amounted to $32 billion. Commitments

extended to the CIS between September 1990 and January 1992 amounted to nearly $79 billion. Of the pledges to Eastern Europe, however, only about one fifth consists of grant aid, although there is in addition a certain grant element in some bilateral loans. The bulk of the assistance to Eastern Europe and the Soviet Union consists of non-concessionary finance and is, therefore, debt-creating. Virtually all loans have been made at market conditions, although there is some implicit subsidy since the Eastern countries either have little access to the international capital markets or have to pay a large premium over base interest rates.

44. The figures for commitments do not of course indicate the actual flows of funds into the transition economies. In the case of the CIS (ex-Soviet Union) gross disbursements in 1990-1991 were about $25 billion, less than one third of commitments. Disbursements lag behind commitments for a variety of reasons and may not occur at all if certain conditions or targets are not met by the potential recipient.

45. For 1990 it is estimated that total gross financial flows - private and official capital plus debt restructuring - to Eastern Europe were $9.7 billion, of which $1.7 billion (less than one fifth) was official aid. Only rough estimates are possible for 1991, but these suggest a doubling of the total gross flow to some $19.8 billion. However, this improvement is not expected to continue: because of an anticipated fall in IMF and G-24 lending, the total in 1992 is expected to be around $14.5 billion. In all three years debt restructuring accounts for a large proportion of the gross flow.

46. In terms of the net transfer of resources the situation is even less promising. In 1990 there was a net outflow of financial resources from Eastern Europe as the withdrawal of funds by commercial banks and large payments for debt servicing by Poland and Hungary more than offset the inflow of new funds. In 1991 there was a net inflow of $4.4 billion, with only Poland continuing to have a net outflow, but it is difficult to be confident that this improvement will continue in 1992. For the Soviet Union, an official net inflow of medium- and long-term assistance of some $6.5 billion in 1990-1991 was more than offset by the withdrawal of a net $15 billion of private short-term credit.

47. Western official financial aid for the countries of Eastern Europe, and for the successor States of the Soviet Union, is, so far, considerably smaller than the sums implied either in a "Marshall Plan equivalent" ($16.7 billion a year) or in the suggestion of the President of the Commission of the European Communities to provide the equivalent level of support as the Community gives to its own depressed regions ($23 billion a year, excluding the former Soviet Union). 21/

48. Inflows of private capital into the Eastern countries have generally been disappointing. Foreign direct investment in Hungary and Czechoslovakia has been encouraging but elsewhere it is negligible. Private banks abroad have reduced their lending, including to these two countries, and in general, as noted above, private capital has tended to flow out of the region. This

suggests that one of the main elements in the Western approach to helping the transition - promoting structural change with large amounts of foreign private capital - has not yet started to work.

49. As regards the mobilization of funds for balance of payments support for the Eastern European countries, the record has been mixed. When it appeared in 1990 that most Eastern European countries would face a financing gap in 1991, partly as a result of the Gulf crisis and higher oil prices, the G-24 and the international financial institutions moved quickly to arrange the necessary credits. These operations proved successful for Czechoslovakia and Hungary, but the necessary financing could not be raised for Bulgaria and Romania. In several cases donor countries did not contribute as much as had been expected. However, the flexibility of the current arrangements also proved inadequate. Creditors tend to adhere to their established practices and timetables for disbursing funds, and there is no arrangement to take up the slack if a major G-24 contributor falls behind schedule in meeting its commitments or fails to contribute as agreed.

50. While some transition countries built up their reserves during 1991, and are perhaps less dependent on the quick disbursal of G-24 funds, the avoidance of further economic and social dislocations in Albania, Bulgaria and Romania is likely to continue to depend on timely access to funds.

51. There continues to be a problem with the overall framework for coordinating assistance to the transition economies. At the last ministerial meeting of the G-24, in November 1991, ministers noted the need for more effective support for the transition process and in particular for a more rapid disbursement of resources, increased information sharing among donors to avoid duplication, and closer cooperation between the international financial institutions and the G-24. 22/ This may be difficult to achieve given the desire of some G-24 Governments and international institutions to guard their independence in such matters and the lack of clear institutional arrangements for overall coordination.

52. The question of coordination 23/ is not just a question of keeping registers of projects and avoiding duplication among donors, important though that may be. Arrangements also need to be made for assessing assistance in relation to the requirements of the transition countries - and for assessing those requirements.

53. Aid and technical assistance are essentially forms of government intervention designed to overcome bottlenecks to economic growth which, for one reason or another, are not being removed by market forces. In countries where the price mechanism is weak, economic rigidities are likely to persist. By definition, this is true, to widely varying degrees, of the transition economies. For private capital to take over the driving role in the transition process, it is necessary to identify first the constraints on private sector growth and the ways in which they might be overcome with official assistance. It is also necessary to identify which of the constraints is binding at any given time in any given country. Thus, in some

of the development models of the 1960s, it was customary to identify constraints arising from inadequate levels of domestic saving or from shortages of foreign exchange: either could restrain the rate of fixed investment, but for effective policy formulation it was necessary to know which one should be targeted. Other constraints may arise from a shortage of skilled labour or, as is likely to be the case in the transition economies, from the absence of crucial elements in the institutional structure required for the existence of (reasonably) efficient markets. To formulate consistent sets of economic policies and focus assistance where it will be most effective thus requires a macroeconomic framework in which government objectives (concerning the growth of output, the unemployment rate, etc.) are related to the effective limits to growth.

54. So far, none of the transition economies or aid-providing countries appear to have adopted such a broad approach to coordination. The background papers occasionally and voluntarily prepared for meetings of the G-24 by the transition countries typically report on recent progress with reform, on recent economic developments and the short-term outlook. Only Poland has produced a fairly comprehensive account of the reforms and projects the Government hopes to implement, but even this refers only to the coming year and does not address the issues in a framework such as that suggested. In this respect a great many useful lessons can be learned from the way in which Marshall Aid for Western Europe was organized in the Organization for European Economic Cooperation.

55. Another advantage of a clearer and more coherent framework for organizing Western assistance for the transition process is that it could play an important role in building confidence in the various reform and restructuring programmes. In some countries, especially some of the members of the CIS, there is a problem of confidence on the part of populations who have seen a series of "plans" come to nothing (or very little) and remain very sceptical towards new sets of proposals. In such circumstances, the credibility of a new reform programme could probably be enhanced with the support of a major international group such as IMF or the G-7. However, to have a significant effect on expectations, the programme should be seen to have been thoroughly analysed and discussed and the support of the international community must be publicly known.

56. More broadly, a clearly defined framework could provide a more "general safety net" for the transition process in which the inevitable mistakes could occur without damaging confidence. It is in such a context that the ECE secretariat has proposed 24/ the creation of a second European recovery programme in which the commitment of Western Governments to the ultimate success of the transition process would be made more explicit. Many historians point to the important role of the confidence effects of Marshall Aid and the United States' commitment to its success in the reconstruction of Western Europe after the war. Today, only the new Eastern German Länder have a similar degree of commitment to the success of their transformation programme.

57. However, this does raise the question of the strength of Western Governments' practical commitment to the reconstruction of Eastern Europe and the former Soviet Union. As noted above, the amounts of genuine aid being given to them are very small and there seems little prospect of a significant increase in the immediate future. Many Western Governments feel constrained by their own budgetary problems and by the deteriorating short-term prospects for their own economic growth. With rising unemployment at home, it is difficult for foreign assistance to qualify as a high priority. Some Governments clearly hope that the problems of the transition economies can be left in large measure to the IMF and the World Bank. However, the IMF is still denied the 50 per cent increase in its quota which is necessary to meet the growing demands on its resources, especially from the Eastern countries, and a $1.3 billion increase in the capital of the International Finance Corporation (IFC) - an affiliate of the World Bank - is still not approved although it is being asked to increase its support for private sector projects. The danger is that the growing introspection of some of the leading Western countries will only be broken by the onset of a major crisis in one of the transition economies and that this could lead subsequently to hasty measures which would probably be less than optimal.

## Notes

1/ For details on the different republics, see Economic Commission for Europe, Economic Survey of Europe in 1991-1992 (United Nations publication, forthcoming), chap. 4.4.

2/ See Economic Commission for Europe, Economic Survey ... 1989-1990 (United Nations publication, Sales No. 90.II.E.1), chap. 3.4.

3/ See the interview with Mr. Otto Schlecht, State Secretary at the Economics Ministry, Bonn, in the Financial Times, 29 April 1991.

4/ President Havel's address was published in English in The New York Review of Books, 7 March 1991, pp. 19-20.

5/ See Dieter Helm, Colin Mayer and Ken Mayhew, "Microeconomic policy in the 1980s", Oxford Review of Economic Policy, vol. 7, No. 3 (autumn), 1991.

6/ See Economic Commission for Europe, Economic Bulletin for Europe, vol. 43 (United Nations publication, Sales No. 97.II.E.39), pp. 4-5.

7/ Detailed studies are still in short supply, but the existence of negative value added, when measured at world prices, has been shown to exist in several manufacturing industries. See G. Hughes and P. Hare, "Competitiveness and industrial restructuring in Czechoslovakia, Hungary and Poland", European Economy, Commission of the European Communities, Brussels, special edition, No. 2, pp. 57-110.

8/ This figure excludes Yugoslavia.

Notes (continued)

9/ On this, see Economic Commission for Europe, Economic Survey ... 1991-1992, chap. 3.2.

10/ See Anders Aslund, letter to the Financial Times, London, 6 March 1992.

11/ Edward Gibbon, The Decline and Fall of the Roman Empire, vol. I (Oxford University Press, World's Classics Edition, 1903), p. 75.

12/ One qualified observer has argued that the majority of personnel running the courts in the Soviet Union were honest and decent people. "But the system as a whole, the entire mechanism of law enforcement ... led to a perversion of the law and the erosion of human rights for all - the accused, the investigators and the judges themselves." Anatoly Sobchak, For a New Russia (London, 1992).

13/ The term is used as in T. D. Weldon, States and Morals (London, John Murray, 1962 edition).

14/ David M. Newberry, "Sequencing the transition", CEPR Discussion Paper Series (London), No. 575, August 1991.

15/ For an extensive discussion, see Economic Commission for Europe, Economic Survey ... 1991-1992, chap. 6.

16/ There is, for example, a lack of expertise in many areas in government and State enterprises which needs to be remedied. There are widespread hopes that privatization and restructuring can be speeded up with the help of Western private capital, but many government officials lack experience in dealing with Western companies and are unfamiliar with international management contracts and competitive bidding methods. Mr. Anthony Pellegrini, Head of the World Bank's infrastructure division, has recently expressed concern in this regard with respect to the water industry in Eastern Europe, where some Western firms have offered local government authorities contracts containing "dubious terms". See Financial Times, 12 March 1992.

17/ For example, contacts between parliamentarians are maintained through the Western European Union, the Council of Europe, the Inter-Parliamentary Union, and so on. Also, within the Conference on Security and Cooperation in Europe (CSCE), the Office for Democratic Institutions and Human Rights will serve as an information exchange for technical assistance available for institution building in the new democracies.

18/ These preconditions for economic assistance are also among the five conditions laid down by the Foreign Affairs Council of the European Community on 16 December 1991, which would have to be met before the independence of any of the Yugoslav republics would be recognized.

Notes (continued)

19/ Uncertainty and the threat of instability in Eastern Europe has also been greatly increased by the disintegration of the Soviet Union. This has not only created severe economic disruption through the sudden collapse of trading links, but has also added to the fears of the Eastern European countries for their security. A framework for cooperation on security issues per se is also developing and includes the CSCE and the new North Atlantic Cooperation Council which met for the first time on 20 December 1991.

20/ For details of the Agreements see Economic Commission for Europe, Economic Survey ... 1991-1992, chap. 5.3.

21/ Economic Commission for Europe, Economic Survey ... 1989-1990. p. 13.

22/ The coordination of emergency aid and other assistance to members of the CIS was discussed at the Washington conference on 22-23 January 1992 and will be followed up at another conference in Lisbon in the spring.

23/ For a more detailed discussion of the coordination issue, and one which places it in the context of proposals for a Second European Recovery Programme, see Economic Commission for Europe, Economic Survey ... 1989-1990, pp. 25-26, Economic Survey ... 1990-1991, p. 7; and Economic Bulletin for Europe, vol. 43 (United Nations publication, Sales No. 91.II.E.39), pp. 8-9.

24/ See Economic Commission for Europe, Economic Bulletin ..., vol. 43, pp. 7-9.

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